Downsizing and Firm Performance: Panacea or Paradise Lost?

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Article:

Downsizing fat and sluggish firms to create lean and mean corporate machines has become a recurring theme in business practices. Consistent with the leaner and meaner mantra is the prevailing belief that downsizing will improve financial indicators and ultimately improve stock price performance. The prevailing logic is straightforward. Firms are bloated and performing poorly due to inefficient processes and excessive bureaucracy. To remedy these inefficiencies organizations need to be rightsized to improve productivity and reduce costs. Whether the rightsizing initiative takes the form of workforce reductions, asset reductions, or both, the decreased costs are expected to either increase earnings via margin improvements or improve competitiveness through greater flexibility. Better earnings and improved competitiveness should logically lead to better financial performance and drive the stock price upward. But is downsizing really an effective mechanism for improving shareholder wealth?

This was the question that researchers Wayne Cascio, Clifford Young, and James Morris, of the University of Colorado at Denver, sought to answer. Their comprehensive study examined 537 companies from the Standard and Poor's (S&P) 500 over a 12 year period. Using a firm's return on assets (ROA) and stock returns as measures of financial performance, Cascio and his colleagues questioned whether downsizing improved financial performance and what types of downsizing worked best.

The researchers also wanted to determine if downsizing firms achieved enhanced financial performance on an absolute basis as well as relative to the industries in which they competed. Firms that successfully adjust their workforce should realize increased employee productivity and reduced costs, thereby increasing their ROA. Firms that improve their performance relative to other firms in the same industry should outperform the average firm in that industry. The researchers' rationale for investigating relative performance within industries was to compare apples to apples since industry differences in competitive conditions may result in apples to oranges comparisons across industries.

Since firms compete under varying market conditions, downsizing also occurs under varied conditions and for different reasons. Sometimes employment levels are downsized in response to budgetary constraints or short-term business fluctuations in an effort to achieve cost competitiveness. Other times, a reduction in assets caused by a divestiture may require a commensurate change in headcount. For this reason, Cascio and his colleagues established several downsizing classifications: Employment downsizers were companies that declined in employment by more than five percent, with a decline in assets (plant and equipment) of less than five percent. Asset downsizers were companies that lowered employment more than five percent and reduced plant and equipment by at least five percent more than the employment reduction. Stable employers were those companies that experienced employment changes of less than five percent. This latter group might be considered the status quo or study control group.

Though the general assumption has been that downsizing of some nature is better than no downsizing at all, the results of this study turn that conventional wisdom on its head. Examining the performance of these S&P 500 firms over the three years following an employment and/or asset downsizing, Cascio and his colleagues discovered an intuitively appealing twist to the common belief about downsizing. Employment downsizers, those focusing on downsizing headcount over physical assets, actually saw a decline in their ROA from approximately 14 per cent to approximately 11 per cent, while stable employers had only a negligible decline in ROA. Further, those organizations with the largest employment declines also experienced the greatest ROA declines. However, after adjusting for industry type, the employment downsizers did not appear to experience significant declines in ROA, suggesting that employment downsizing neither helped nor hindered ROA.

In sharp contrast, ROA increased for the asset downsizers (those adjusting assets more than employment). ROA for asset downsizers rose from 11 per cent to 14 per cent and after adjusting for industry type, the ROA increase for these asset downsizers was four per cent. For stable employers, ROA increase was one per cent after adjusting for industry type. In short, only asset downsizers improved ROA and stable employers fared better than employment downsizers.

Despite the negligible impact of downsizing on firm profitability, the stock price performances of the downsizing firms were generally better than the average for their industries. The researchers used the cumulative industry-adjusted return (CIAR) to compare the effectiveness of downsizing strategies. At the end of the three-year period following the downsizing event, the CIAR was relatively unchanged for stable employers, up 6 per cent for employment downsizers, and up 28 per cent for asset downsizers. These results, which are consistent with those found for ROA, indicate that organizations that combine employment downsizing with asset restructuring experience better financial performance and achieve greater stock returns than their industry peers.

Though perhaps counter to conventional wisdom, one explanation for the results of this study may be a lack of appreciation for the softer longterm costs associated with employment-driven downsizing. For example, downsizing may severely affect employee motivation, leading to employee behaviors that hinder rather than enhance productivity. Consequently, productivity decrements may offset labor cost savings, resulting in the basically flat relative financial and share price performance observed here.

The results of this study suggest that the astute manager in search of a panacea for increasing shareholder wealth will undertake a downsizing initiative that systematically considers both physical assets and human assets in concert. A quick fix employment-driven downsizing that caters to the prevailing wisdom that all forms of downsizing are desirable is more likely to result in a feeling of paradise lost.

Source:

Wayne F. Cascio, Clifford E. Young, and James R. Morris. Financial consequences of employment-change decisions in major U.S. corporations.